

**RULE ENFORCEMENT REVIEW
OF THE
NEW YORK MERCANTILE EXCHANGE**



**Division of Market Oversight
September 16, 2004**

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RULE ENFORCEMENT REVIEW OF THE NEW YORK MERCANTILE EXCHANGE

I. INTRODUCTION: PURPOSE AND SCOPE

The Division of Market Oversight (“Division”) has completed a rule enforcement review of the audit trail, trade practice surveillance, disciplinary, and dispute resolution programs of the New York Mercantile Exchange (“NYMEX” or “Exchange”) for compliance with related core principles under Section 5(d) of the Commodity Exchange Act (“Act”) and Part 38 of the Commission’s regulations. The review covers the period of January 1, 2003 through December 31, 2003 (“target period”).¹

Specifically, the Division evaluated the Exchange’s compliance with five core principles: Core Principle 10– Trade Information and Core Principle 17- Recordkeeping, relate to the maintenance of an audit trail that can be used to assist a contract market in the identification and prosecution of customer and market abuses and the maintenance of trade-related records; Core Principle 2- Compliance with Rules and Core Principle 12- Protection of Market Participants, relate to surveillance, enforcement, and disciplinary procedures used by a contract market to protect market participants from abusive trading practices; and Core Principle 13- Dispute Resolution, relates to fair and equitable dispute resolution procedures for customer and member-

¹ This review does not include the COMEX Division of the NYMEX. Rule enforcement reviews prepared by the Division are intended to present an analysis of an exchange’s overall compliance capabilities for the period under review. Such reviews deal only with programs directly addressed in the review and do not assess all programs. The Division’s analyses, conclusions, and recommendations are based, in large part, upon the Division’s evaluation of a sample of investigation and disciplinary case files, and other exchange documents. The evaluation process, in some instances, identifies specific deficiencies in particular exchange investigations or methods but is not designed to uncover all instances in which an exchange does not address effectively exchange rule violations or other deficiencies. Neither is such a review intended to go beyond the quality of the exchange’s self-regulatory systems to include direct surveillance of the market, although some direct testing is performed as a measure of quality control.

to-member disputes.²

To assess the Exchange's compliance with these core principles, Division staff reviewed numerous documents used by the NYMEX's Compliance Department ("Compliance" or "Compliance Department") in performing the Exchange's self-regulatory responsibilities. These documents included, among others, computer reports and other documentation used routinely for audit trail enforcement and trade practice surveillance; trading card and order ticket reviews; trade practice investigation and inquiry files; disciplinary action files; investigation, inquiry, recordkeeping, audit trail, disciplinary, and floor surveillance logs; minutes of disciplinary committee meetings held during the target period; and Compliance guidelines. In addition, Division staff interviewed senior Compliance officials, including the Senior Vice President of Compliance and Risk Management, the Vice President of Compliance, the Associate Counsel, the Director and Associate Director of Trade Practice Surveillance, and a Senior Manager.³

The Division provided the Exchange an opportunity to review and comment on a draft of this report on August 12, 2004. On August 31, 2004, Division staff conducted an exit conference with Exchange officials to discuss the report's findings and recommendations.

² Appendix B to Part 38 of the Commission's regulations provides guidance concerning the core principles with which a designated contract market must comply to maintain its designation. In addition, Appendix B provides acceptable practices for several of the core principles. Although the acceptable practices establish non-exclusive safe harbors, they do not establish a mandatory means of compliance with the core principles. Appendix B provides acceptable practices for Core Principles 2, 10, 13, and 17. However, acceptable practices are not set forth for Core Principle 12. In promulgating Part 38, the Commission reserved the authority to adopt acceptable practices for Core Principle 12 at a later date.

³ A copy of the March 5, 2004 interview transcript can be found in Appendix 1. Cites to the transcript are herein referenced as "Transcript, p. _."

II. SUMMARY OF FINDINGS AND RECOMMENDATIONS

A. Audit Trail Program

Findings

- The Exchange's audit trail program provides for the recording and safe storage of trade information in a manner that allows staff to use the information to assist in the prevention of customer and market abuses and to provide evidence of rule violations.
- The Exchange conducts annual trading card reviews of each floor member and bimonthly order ticket reviews of selected floor members to assess members' compliance with recordkeeping requirements. The order ticket and trading card reviews were thorough, well documented, and completed in a timely manner.
- The Exchange's methodology for selecting members for order ticket reviews does not provide for sufficient coverage of the floor population. During the target period, only nine of its approximately 263 floor brokers were examined for compliance with order ticket recordkeeping requirements.
- Trade execution times are assigned to each trade based on pit card timestamps. Pit cards are required to be submitted by the seller within one minute of execution. Members with pit card submission timeliness rates below 80 percent for outright trades are subject to warning letters and graduated summary fines. However, spread trades are not included in the summary enforcement program, which has resulted in significantly lower rates of compliance for spread trades versus outright trades.

Recommendations

- **The Exchange should include spread transactions in its pit card/one-minute trade timing summary enforcement program.**
- **The Exchange should increase the number of broker groups and individual floor brokers reviewed annually in routine floor order ticket reviews to a level that would ensure that a sample of each broker's floor order tickets are subject to examination within a reasonable period of time.**

B. Trade Practice Surveillance Program

Findings

- The Exchange maintains an adequate trade practice surveillance program that is administered by an experienced staff.
- The Exchange uses, among other things, a computerized trade practice surveillance system and floor surveillance to monitor its markets for potential trading violations. During the target period, the Exchange opened 109 investigations and closed 105 investigations, including 20 investigations that were referred for disciplinary action. Most of the investigations were generated from the computerized surveillance system.
- Investigations were thorough and well documented, and investigation reports included sufficient analyses to support Compliance staff's conclusions and recommendations. In addition, investigations were expanded to include additional trading dates or members where appropriate.
- During the target period, the Exchange focused on closing aged investigations. In this connection, the Exchange closed 16 investigations that had been open for more than one year. Thirteen of these 16 investigations resulted in referrals for disciplinary action. By the end of the target period, the Exchange had accomplished its goal of having no investigation on its log open for more than one year.

The Division has no recommendations in this area.

C. Disciplinary Program

Findings

- The Exchange took disciplinary action against 16 members, one member firm, and one clearing member in 16 separate cases. The sanctions imposed by the Exchange in the majority of the cases appear reasonable relative to the violations committed.
- All of the cases were resolved through Adjudication Committee settlement agreements. Eleven involved trade practice violations, four involved recordkeeping violations, and one was primarily a market surveillance case with trade practice elements. The sanctions assessed by the Exchange included a total of \$2,718,500 in fines, five suspensions, and three instances of customer restitution totaling \$27,510.

- In five of the 16 cases, the Adjudication Committee did not follow the Compliance Department's recommendations for more substantial sanctions, including sanctions imposed on some repeat offenders. This raises concerns as to the adequacy of the sanctions imposed in these cases. In addition, in two of the five cases, restitution was calculated and recommended by Compliance staff, but was not included in the final settlements.

Recommendations

- **Exchange disciplinary committees should give careful consideration to Compliance staff's recommended sanctions, and, in those instances where the committees' sanctions ultimately differ from those recommended by Compliance, the committees should articulate their rationale in committee minutes.**
- **Exchange disciplinary committees should ensure that all sanctions and settlements are sufficient to serve as an effective deterrent, particularly in those cases involving repeat offenders.**
- **Restitution should be ordered in settlements and Exchange disciplinary decisions where the amount of customer harm can reasonably be determined.**

D. Dispute Resolution Program

Findings

- The Exchange's arbitration rules provide fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by unbiased panels, including panels where a majority of the panelists are not members of, or associated with, any member of a contract market.
- The Exchange's arbitration rules require a prompt hearing and authorize prompt, written awards that are not subject to appeal within the Exchange.
- The one dispute decided during the target period was resolved in accordance with Exchange rules and procedures.

The Division has no recommendations in this area.

III. AUDIT TRAIL PROGRAM

Core Principle 10 – Trade Information:

The board of trade shall maintain rules and procedures to provide for the recording and safe storage of all identifying trade information in a manner that enables the contract market to use the information for purposes of assisting in the prevention of customer and market abuses and providing evidence of any violations of the rules of the contract market.

Core Principle 17 – Recordkeeping:

The board of trade shall maintain records of all activities related to the business of the contract market in a form and manner acceptable to the Commission for a period of five years.

Pursuant to the acceptable practices set forth in Appendix B to Part 38 of the Commission's regulations, an effective contract market audit trail should capture and retain sufficient trade-related information to permit contract market staff to detect trading abuses and to reconstruct transactions within a reasonable period of time. In addition, the contract market must create and maintain an electronic transaction history database that contains information with respect to transactions executed on the designated contract market. An acceptable audit trail also must be able to track a customer order from time of receipt through fill allocation or other disposition. Further, an acceptable audit trail should include original source documents, transaction history, electronic analysis capability, and safe storage capability.

Original source documents include unalterable, sequentially identified records on which trade execution information is originally recorded, whether manually or electronically. A transaction history consists of an electronic history of each transaction, including all data that are input into the trade entry or matching system for the transaction to match and clear. These data should include the categories of participants for whom such trades are executed; timing and sequencing data adequate to reconstruct trading; and the identification of each account to which fills are allocated. An electronic analysis capability permits sorting and presenting data included

in the transaction history so as to reconstruct trading and to identify possible trading violations, while safe storage capability provides for a method of storing the data included in the transaction history in a manner that protects the data from unauthorized alteration, accidental erasure, or other loss.

Commission Regulation 1.31 governs the manner in which an exchange is required to maintain trade-related records. The regulation mandates that all records required to be kept under the Act or Commission regulations be maintained for five years and be readily accessible during the first two years. Most categories of required records may be stored on either micrographic or electronic storage media for the full five-year maintenance period. However, trading cards, documents on which trade information is originally recorded in writing, and order tickets, must be retained in hard copy for five years.

A. Order Flow and Recordkeeping Procedures

Open outcry orders at NYMEX are typically transmitted to the trading floor either by telephone or electronically through the Trade Order Processing System, an industry-wide order routing system, or through a member's proprietary order routing system. Telephone orders are immediately written-up on an order ticket by a floor broker's clerk and stamped with an entry timestamp. The information documented on an order ticket must be recorded in non-erasable ink, and include the terms of the order, a customer identifier, and an order number. The order ticket is timestamped again when report of execution is made. For all electronically transmitted orders, the order routing system automatically prints an order ticket that includes the terms of the order, a customer identifier, an order number, and the time of the order.⁴ Once an order is filled, the floor broker or his or her clerk records the fill price in writing on the order ticket. The order

⁴ NYMEX Rule 6.18(A)(ii) lists the requirements for floor order tickets.

ticket is then brought back to the clerk's booth, where the clerk confirms the fill to the customer and timestamps the order ticket a second time.

The Exchange requires that each member promptly record all executed transactions on a sequentially numbered, pre-printed trading card that is issued by the Exchange.⁵ The Exchange provides members with an integrated pad that consists of two sets of documents, the trading card and the pit card. The top document on the pad is the trading card, which consists of three soft-ply (one original and two copies), color coded sheets, with spaces for up to nine trades. The bottom document consists of four sequentially numbered hard-ply pit cards that are virtual duplicates of the trading card. When trade information is recorded on the trading card, that information is concurrently recorded on the uppermost pit card. The seller then must submit the pit card within one minute of the transaction by throwing the card into a netted area in the center of the pit where an Exchange employee retrieves and timestamps the card.⁶ This timestamp represents the one-minute execution time.⁷

⁵ NYMEX Rule 6.90 requires members to record information for all transactions, including the member's symbol, opposite member, clearing member, date, price differential or premium, commodity, quantity, delivery month or expiration date, and additionally, for options, strike price and a put/call indicator. With the exception of trades executed on the open or close, members must record the execution time of the first trade made on each trading card. In addition, all trades must be recorded in non-erasable ink, in exact chronological order of execution, on sequential lines of the trading card without skipping lines between trades. Any remaining lines on a trading card must be crossed out. Errors on cards may be corrected, but originally recorded information may not be obliterated or otherwise made illegible. Trades made during an exchange's opening and closing periods must be separately identified.

⁶ Trade information recorded on the trading card is duplicated onto the then-uppermost pit card. As a result, all of the trade data recorded on the trading card is also recorded on one or more associated pit cards. The pit card (and trading card) reflects essential trade matching data, including the commodity, date, identity of the executing and opposite broker, contract month, and price (or, in the case of spreads, the differential). For option trades, the pit card also reflects the strike price and a put/call indicator. In addition, with the exception of trades executed during the opening or closing ranges, Exchange members are required to manually record the execution time of the first trade made on each trading card.

⁷ Pursuant to NYMEX Rule 6.90(D), pit cards are used to report the sale of futures and options contracts within one minute of execution in accordance with NYMEX Rule 6.10. Additionally, if any hard-ply contains only purchases of futures or options contracts, the floor member must submit the hard-ply of the trading card, *i.e.*, the pit card, to the Exchange prior to using the next sequentially numbered trading card. This pit card is normally time stamped but the timestamp is not entered into the Exchange's Trade Matching System ("TMS"). However, the pit card can be used to assist in the reconstruction of trading.

After the pit card is time stamped, the trade data are entered into the Trade Matching System (“TMS”) by Exchange data entry personnel. Within approximately 4 to 10 minutes, the pit card data appear on both the buyer’s and seller’s computer screens for validation and entry of the remaining required data for clearing, including customer identifier, customer type indicator (“CTI”) code, and clearing member identifier.⁸ The completed data are used for clearing purposes and become the basis for the “Streetbook,” the Exchange’s daily trade register, and TXN, the Exchange’s automated trade monitoring system.⁹

With respect to customer orders entered on ACCESS, the Exchange’s internet-based electronic trading system, NYMEX Rule 6.22(D) requires that customer orders be immediately entered into the system within one minute of receipt, or, if such orders cannot be entered into the system within one minute of receipt, they must be recorded on a paper order ticket and time stamped within one minute of receipt, and entered into the system as soon as practicable.¹⁰ ACCESS orders, like floor orders, must contain the terms of the order, CTI code, clearing member, and account designation. ACCESS automatically records the order number, time of entry into the system, and the time that the order is matched. ACCESS also automatically records the time of any modifications made to an order before it is matched.

All of the trade data that comprise NYMEX’s audit trail, for both open outcry and

⁸ NYMEX Rule 9.04(M) requires that the customer account number, clearing member number, and CTI code be submitted to the Exchange by the executing floor member within one hour after the initial transfer information is supplied by the Exchange.

⁹ TXN is the name of the firm that originally provided the Exchange with the first version of its automated trade surveillance system.

¹⁰ NYMEX ACCESS lists the Exchange’s energy, platinum, and palladium futures contracts, as well as COMEX metals futures contracts, for after-hours trading. NYMEX ACCESS market participants who have successfully executed a Primary Clearing Member Agreement and a NYMEX ACCESS User Agreement may trade NYMEX ACCESS contracts through personal computers. The Exchange’s other electronic trading system, ClearPort, is an internet-based system that allows market participants to trade futures contracts that replicate popular OTC energy derivatives, or market participants may conduct their own off-exchange transactions, negotiate their own prices, and submit the transactions for clearing through the ClearPort clearing system. Market participants primarily use

ACCESS trades, are contained in the Streetbook. The Streetbook, along with timing and sequencing information from order tickets, trading cards, and the Price Change Register (“PCR” or “time and sales”), allows Exchange staff to reconstruct transactions for investigation and evidentiary purposes.

B. One Minute Timing Compliance

The Exchange monitors members’ compliance with the one-minute pit card submission requirement through use of the Pit Card Validation Report. This report compares pit card times to trade times appearing on the PCR for all outright and intra-commodity spread transactions. The Pit Card Validation Report reflects all outright and intra-commodity spread sell transactions for each member, the number and percentage of such transactions which are valid and invalid, and, for those that are invalid, the number of minutes that the pit card is late. The report deems a trade to be valid when the PCR shows a print of the trade price at a point during the minute before, the minute of, or the minute after the actual timestamp on the transaction’s pit card.

To assess the accuracy of the Exchange’s pit card times, the Division reviewed the Pit Card Validation Report for two randomly selected days during each of the 12 months within the target period. The combined daily percentage of compliance with the Exchange’s one-minute timing standard for outright and intra-commodity spreads ranged from 83 percent to 90 percent, with an overall average of 87 percent. The daily percentage of compliance with the Exchange’s one-minute timing standard for outright trades ranged from 85 percent to 91 percent, with an overall average rate of 88 percent. However, the daily percentage of compliance with the Exchange’s one-minute timing standard for intra-commodity spread transactions was significantly lower, ranging from 69 percent to 86 percent, with an overall average rate of 78

ClearPort to clear off-exchange transactions.

percent.

To enforce the requirement that pit cards be timely submitted and to ensure the accuracy of one-minute trade times, Compliance assesses the pit card timing accuracy of all trading members for outright trades on a monthly basis. Members with compliance rates below 80 percent are subject to warning letters and graduated sanctions.¹¹ During the target period, the Exchange levied 26 fines of \$5,000, 21 fines of \$2,500, 31 fines of \$1,000, 25 fines of \$750, 39 fines of \$500, and 51 fines of \$250, for a total of \$264,500, and issued 332 warning letters. Compliance also forwarded one investigation to the BCC for further action.¹² In addition, in order to determine if late pit cards may implicate any type of trade practice violation, the Compliance Department periodically initiates trade practice inquiries or investigations into the trading activities of members who consistently fail to meet the 80 percent threshold. Six such investigations were opened during the target period.¹³

In an effort to reduce pit card timing violations and recidivism by members, the

¹¹ Compliance issues warning letters for the first three monthly failures to meet the threshold by brokers whose total number of transactions (sales) was 100 or greater. For subsequent offenses, progressively increasing fines are imposed. A member is cited each month his or her audit trail percentage falls below 80 percent. However, a member who experiences a four-month violation-free period will be granted a clean slate for purposes of a subsequent offense. The fine schedule is as follows: \$250 for the first failure to meet the threshold following the third warning letter; \$500 for the next violation; \$750 for the next violation; \$1,000 each for the next three violations; \$2,500 each for the next three violations; and \$5,000 each for the next three failures to meet the 80 percent threshold. Every fourth \$5,000 fine will result in a referral to the BCC with a recommendation that a complaint be issued for violation of Exchange Rule 8.55(B)(8), "To Fail Consistently to Conform to Audit Trail and/or Trade Submission Standards," a minor offense, and Floor Rule 6.10(A), "Reporting of Trades Executed on the Trading Floor." *See* September 14, 1998 Notice to Members and May 22, 2001 Notice to Members attached as Appendix 2.

¹² Investigation 06-396. This case was settled after the target period with the respondent agreeing to pay a \$25,000 fine, of which \$20,000 will be suspended if the respondent is not fined for similar violations within a 12-month period from the date the settlement became final.

¹³ Investigation 06-376 resulted in the issuance of a Compliance warning letter for failure to comply with the Exchange's trading card recordkeeping requirements and Investigation 03-450 was closed with no recommended action. Investigations 06-372, 06-448, 06-449, and 06-478 remained ongoing at the close of the target period. Since that time, Investigation 06-449 was closed with a Compliance warning letter, and Compliance has recommended charges in Investigation 06-372 for three instances of trading ahead of customer orders. Investigation 06-448 and 06-478 were still open as of July 7, 2004.

Compliance Department recently developed a program to educate the floor population regarding the Exchange's audit trail requirements and procedures. As part of this program, the Associate Compliance Counsel conducts periodic classes for members repeatedly fined for late pit card submissions. The program's purpose is to improve NYMEX's overall audit trail by educating members, identifying individual issues, tailoring individual solutions, and providing statistical follow-up. Members, as well as their clerks, are encouraged to attend these classes.

Although the Pit Card Validation Report includes intra-commodity spread transactions as well as outright trades in its trade timing accuracy calculations, members are not subject to sanctions for non-compliance with respect to one-minute trade timing for spreads.¹⁴ The Division believes that this may explain why members' compliance with the Exchange's one-minute trade timing requirement is significantly lower for spread trades than for outright trades, and recommends that spreads be subject to the same trade timing enforcement program utilized for outright trades. In this manner, the Exchange's accuracy rate for spread execution times should improve from its current low level of 78 percent.

C. Recordkeeping: Trading Cards and Order Tickets

1. Trading Cards

To evaluate and enforce members' compliance with the Exchange's trading card recordkeeping requirements, the Compliance Department conducts an annual review of three days of original trading cards for each floor member and administers a summary disciplinary program.¹⁵ Based upon levels of compliance with eight categories of requirements included in a

¹⁴ Transcript, p. 46.

¹⁵ Compliance typically selects a target week and examines the trading cards of approximately 55 members, 10-15 of whom are selected based upon receipt of a warning letter or fine as a result of a previous review. The remaining 40-45 members are selected from a monthly computer report as part of the effort to assure that each member is reviewed at least once annually.

Compliance Department checklist, members are determined to be in “Full Compliance,” “Effective Compliance,” or “Not in Compliance.”¹⁶

A member with no discrepancies in any of the eight categories would be in Full Compliance, a member with a compliance rate of 90 percent or better in categories one through three, no more than two violations in category four, and no discrepancies in categories five through eight, would be in Effective Compliance, and a member who failed to meet these standards would be deemed Not in Compliance. Members found to be in the latter category are subject to disciplinary action. Under the Exchange’s summary disciplinary program, the Compliance Department issues a warning letter for the first finding of Not in Compliance. A second infraction within a 12-month period results in a \$100 fine; and a third infraction within 18 months results in a \$500 fine. A fourth infraction within 24 months results in a referral to the BCC for formal disciplinary action.¹⁷

NYMEX completed 517 of the 577 trading card reviews it initiated during the target period. As a result of the 517 completed reviews, Compliance issued 328 Full Compliance letters, 77 Effective Compliance letters, and 71 warning letters.¹⁸ The Exchange also assessed fines totaling \$15,300 for trading card infractions. This amount included 28 fines of \$100 and 25 fines of \$500.¹⁹ In addition, Compliance forwarded four cases to the BCC for formal

¹⁶ The eight categories include: 1) time recorded next to the first trade on each card; 2) identification of the open or close and marking through unused lines; 3) buys and sells recorded sequentially in chronological order without skipping or sharing lines; 4) drawing a single line through erroneous information; 5) using non-erasable ink; 6) cards used are maintained by the floor member; 7) cards are used in numerical sequence day-to-day; and 8) cards that are not used, or are rewritten by the floor member, are maintained. A copy of the checklist can be found in Appendix 3.

¹⁷ NYMEX Rule 6.90(G).

¹⁸ The Compliance Department also issued 19 warning letters to members for failure to maintain all trading cards, a violation of NYMEX Rule 8.50(B).

¹⁹ Three of the \$100 fines and nine of the \$500 fines were assessed for violations that occurred prior to the target period.

disciplinary action.²⁰

The Division examined 36 trading card reviews that resulted in warning letters or fines during the target period and the four trading card reviews that were forwarded to the BCC. During the course of the 40 reviews, the Compliance Department examined 2,049 trading cards. The Division found that the trading card reviews were thorough and completed in a timely manner, and that non-compliant members were disciplined in accordance with the Exchange's summary fining schedule. The Division believes that NYMEX has adequate procedures for reviewing and enforcing compliance with its trading card recordkeeping requirements.

2. Order Tickets

To evaluate member compliance with the Exchange's order ticket recordkeeping requirements, the Compliance Department conducts order ticket reviews and reviews order tickets during the course of trade practice investigations. In contrast to trading card reviews, the Division found that the Exchange completed relatively few order ticket reviews during the target period.

Order ticket reviews, which are alternated monthly between NYMEX and COMEX members, consist of an examination of a minimum of 30 hand-written floor order tickets from one "broker group" per month.²¹ Typically, a broker group is selected for review based upon the appearance of the order tickets examined during the course of an investigation.²² Although the Exchange selects a representative sample of the broker group's business for the selected date,

²⁰ Investigation 06-359 was settled and the subject member was fined \$2,500. Three of the four disciplinary cases remained open at the close of the target period but were subsequently closed. These matters, Investigations 06-430, 06-457, and 06-456, were settled and each of the respective respondents was fined \$1,500.

²¹ A broker group on NYMEX is a business entity composed of one or more brokers who execute customer orders and are paid their transaction fees collectively through the Automatic Transfer of Money system.

²² In conducting an investigation, an analyst obtains the member's trading records for the entire day. If there are deficiencies in any of the order tickets that are critical to determining whether a rule violation occurred, the

each member of the group will not necessarily have his or her order tickets reviewed. The floor order tickets selected are examined for the required account identification and timestamps. All filled or partially filled orders are required to have entry and exit timestamps; unfilled or canceled orders are required to have at least the entry timestamp; and orders for which the terms have changed are required to have a timestamp which corresponds to the change.²³

A branch order ticket review also is initiated bi-monthly.²⁴ Compliance selects order tickets associated with one futures commission merchant (“FCM”) and obtains related floor order tickets. Compliance then conducts a review similar to that performed for floor order tickets for between 10 and 15 corresponding branch order tickets. The Compliance Department reviews the branch order tickets to determine if the terms of the orders and customer account numbers/designations correspond to those on the floor order tickets. Compliance also compares the timestamps on both sets of order tickets to the associated pit card times and time and sales prints in order to assure that they all correspond. Broker groups and FCMs found not to be in compliance with recordkeeping requirements are subject to disciplinary action. A finding of 90 percent or better compliance results in no action. During the target period, compliance of 80 to 89 percent, in either the first or second review, resulted in the issuance of a Compliance warning letter, and compliance of 79 percent or below resulted in a BCC warning letter and a follow-up review. Compliance of 79 percent or below following the second review resulted in referral to

member’s broker group is automatically issued a warning letter and is scheduled for a full order ticket review.

²³ The analyst uses a detailed checklist that requires that he or she test for, among other things, carbon copies with account numbers written in ink, which may indicate that the account number was obtained after the order was filled. A copy of a checklist used in these reviews can be found in Appendix 4.

²⁴ Comparatively few floor order tickets have corresponding branch order tickets. Excluding machine-generated order tickets routed via order routing systems, approximately 80 to 90 percent of the orders received on the Exchange floor are telephoned directly to floor brokers by customers. As a result, branch order ticket reviews are initiated independently of floor order ticket reviews to ensure that an appropriate sample is reviewed.

the BCC for the issuance of a complaint.²⁵

The Exchange completed eight floor order ticket reviews during the target period, examining a total of 324 floor order tickets from nine floor brokers. The Exchange found that 304 of the 324 order tickets examined (94 percent) contained an account identifier and that 296 of the order tickets (91 percent) contained required timestamps. As a result of the eight floor order ticket reviews, one broker group was issued a Compliance warning letter for failure to properly time stamp floor order tickets.²⁶

The Exchange also completed seven branch office order ticket reviews during the target period, examining a total of 78 branch office order tickets. All of the tickets had appropriate account identification and order terms that corresponded to the associated floor order tickets, and 74 tickets (95 percent) contained appropriate timestamps. As a result of the branch order ticket reviews, Compliance issued two warning letters to two firms.

The Division's examination of the Exchange's order ticket reviews indicated that the reviews were thorough and well documented. However, the Division believes that the Exchange's routine bimonthly floor order ticket review does not provide for sufficient coverage of the Exchange's floor broker population. During the target period, the Exchange reviewed

²⁵ Subsequent to the target period, on June 3, 2004, the Exchange adopted NYMEX Rule 8.70, which imposes a summary fining schedule for order ticket recordkeeping violations. Under the new rule, after an initial order ticket review, the Compliance Department may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent - \$100, (2) 79 to 70 percent - \$250, (3) 69 to 60 percent - \$500, and (4) 59 percent and below - \$1,000. If after a second review an entity fails to achieve a passing compliance rate, the Compliance Department may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent – the amount of the first fine plus \$100, (2) 79 to 70 percent – the amount of the first fine plus \$250, (3) 69 to 60 percent – the amount of the first fine plus \$500, and (4) 59 percent and below – the amount of the first fine plus \$1,000. If after a third review an entity fails to achieve a passing compliance rate, the Compliance Department may impose fines corresponding to the following rates of compliance: (1) 89 to 80 percent – the amount of the second fine plus \$100, (2) 79 to 70 percent – the amount of the second fine plus \$250, (3) 69 to 60 percent – the amount of the second fine plus \$500, and (4) 59 percent and below – the amount of the second fine plus \$1,000. The Compliance Department may, in its discretion, refer to the BCC any entity that fails to achieve a compliance rate of 69 percent after a third review.

²⁶ Another investigation, Investigation 04-354, was to be presented before the BCC for improper account identifiers but was closed by the Compliance Department without action after the principal of the broker group retired and

floor order tickets for only nine of its approximately 263 floor brokers in connection with order ticket reviews. Although the Division recognizes that the Exchange also reviews orders tickets during the course of investigations, the Exchange's current methodology for conducting floor order ticket reviews results in many brokers not being subject to a routine floor order ticket review for an extended period of time. It is important to conduct floor order ticket reviews on a routine basis not only because they may reveal recordkeeping deficiencies, but also, and more importantly, because doing so may identify irregularities on the face of an order that may underlie substantive violations, such as alteration of an account number to allocate fills to a favored account. Therefore, the Exchange should take appropriate steps to ensure that more broker groups and individual floor members are reviewed annually in connection with routine order ticket reviews.

D. Safe Storage Capability

All NYMEX audit trail data, which includes trade data from the Streetbook and time and sales sequencing data, are maintained in TXN, the Exchange's automated trade surveillance system. The Exchange has the ability to access TXN data back to 1998. The Exchange maintains these data on two independent dedicated computers, the "production" machine and the "hot backup," which mirrors the production machine. Compliance Department data also are stored in both computers and staff can seamlessly switch back and forth between the machines as needed. Incremental back-up of data to tape is performed daily and a full back-up to tape is performed weekly. Tapes are stored off site at a private storage facility for approximately four weeks and then periodically sent to the Exchange's back-up trading facility located on Long Island, New York. The full back-up tapes are maintained for at least seven years and the

dissolved the association.

incremental tapes are recycled after a period of three months.

E. Conclusions and Recommendations

The Division found that the Exchange maintains an adequate audit trail program. Pursuant to Core Principle 10, the Exchange maintains rules and procedures that provide for the recording and safe storage of trade data, time and sales data, and historical transactions in a manner that enables the Compliance Department to use the information in its automated surveillance system to assist in the prevention of customer and market abuses and to provide evidence of any rule violation. In addition, the Exchange retains audit trail data for seven years, two years more than the five years required by Core Principle 17.

The Exchange uses the Pit Card Validation Report to assess the timeliness of pit card timestamps that are used to assign one-minute trade times. This report compares pit card times to trade times appearing on the time and sales for outright and spread transactions. Members with pit card submission timeliness rates below 80 percent for outright trades are subject to warning letters and graduated summary fines. However, the summary enforcement program is not used to enforce trade timing for spreads. The Division's review of the Pit Card Validation Report for randomly selected days during the target period disclosed that the percentage of compliance for spread transactions was 78 percent, significantly lower than the percentage of compliance for outright trades, 88 percent, and should be improved.

The Exchange's audit trail program also includes annual trading card reviews of each floor member and bimonthly order ticket reviews to examine members' compliance with recordkeeping requirements. The Division found that the Exchange's order ticket and trading card reviews were thorough, well documented, and completed in a timely manner. However, the Division found that the Exchange's selection methodology for order ticket reviews does not

provide for sufficient coverage of the Exchange's floor broker population. During the year-long target period, the Exchange reviewed the floor order tickets of only nine of its approximately 263 floor brokers. The Exchange's selection methodology, therefore, results in many brokers' floor order tickets not being reviewed for an extended period of time.

Based on the foregoing, the Division recommends that the Exchange:

- **Include spread transactions in its pit card/one-minute trade timing summary enforcement program.**
- **Increase the number of broker groups and individual floor brokers reviewed annually in routine floor order ticket reviews to a level that would ensure that a sample of each broker's floor order tickets are subject to examination within a reasonable period of time.**

IV. TRADE PRACTICE SURVEILLANCE PROGRAM

Core Principle 2 – Compliance with Rules:

The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

Core Principle 12 – Protection of Market Participants:

The board of trade shall establish and enforce rules to protect market participants from abusive practices committed by any party acting as an agent for the participants.

Pursuant to Appendix B to Part 38 of the Commission's regulations, a contract market's trade practice surveillance program should have the arrangements, resources, and authority necessary to perform effective rule enforcement. The arrangements and resources attendant to the program should facilitate the direct supervision of the contract market, including analysis of relevant data. An acceptable program should have systems that maintain all data reflecting the details of each transaction executed on the contract market. In this regard, the program should include routine electronic analysis of these data to detect potential trading violations. The program also should provide for appropriate and thorough investigation of all potential trading violations brought to the contract market's attention, including member and Commission referrals and customer complaints. In addition, the program should have the authority to discipline, suspend, or terminate the activities of members or market participants pursuant to clear and fair standards.²⁷

²⁷ That aspect of Core Principle 2 that relates to the disciplining of members who violate Exchange rules is discussed below in Section V. This section of the report addresses the Exchange's program for monitoring its markets for possible trading abuses and the investigation of any identified abuses.

A. Compliance Staff

The Compliance Department, whose staff is responsible for detecting, investigating, and prosecuting potential trading violations on both the NYMEX and COMEX Divisions, is directed by the Senior Vice President of Compliance and Risk Management.²⁸ The Vice President of Compliance assists the Senior Vice President in the day-to-day management of the Exchange's trade practice and market surveillance programs, and is responsible for the Compliance Department's legal program, which includes a Compliance Counsel and an Associate Compliance Counsel.²⁹

The Director of Trade Practice Surveillance has overall responsibility for investigating and prosecuting rule violations.³⁰ The Director manages a trade practice staff that includes an Associate Director, four senior managers, one manager, six analysts (including one senior analyst and two experienced analysts), and one clerk. The Associate Director and managers oversee investigations and provide general guidance to the analysts and clerk.³¹ The analysts review trading activity and trading documents, analyze computerized exception reports, conduct

²⁸ The Senior Vice President of Compliance and Risk Management, who has been with the Exchange for 17 years, is responsible for the Exchange's trade practice surveillance, market surveillance, and risk and financial management programs. He began his Exchange career in the market surveillance area and previously served in the positions of Director of Market Surveillance and Vice President of Compliance.

²⁹ The Vice President of Compliance has more than 15 years of exchange experience. She served as COMEX Compliance Counsel from 1989 until 1994, when COMEX merged with NYMEX, and was then named as NYMEX Associate Compliance Counsel. In 1998, she was promoted to Compliance Counsel and held that position until December 2002, when she was promoted to her current position. The Compliance Counsel, who is responsible for prosecuting trade practice violations, has significant industry experience that includes seven years as a COMEX/NYMEX investigator, two years as an attorney with the Commission's former Division of Trading and Markets, and two years as Vice President of Compliance and Compliance Counsel for an FCM. He has been in his current position for 15 months.

³⁰ The Director of Trade Practice Surveillance is a former COMEX floor trader. He has worked for the Exchange for the past 11 years and has held his present position for the past six years.

³¹ NYMEX's trade practice surveillance staff has significant exchange and industry experience. The Associate Director, who has 21 years of combined COMEX/NYMEX experience started as a COMEX investigator in 1983 and was a manager at the time of the NYMEX/COMEX merger. He has served in his present position since 2001. One of the senior analysts and one of the analysts are former NYMEX or COMEX members. In addition, the senior analyst spent 11 years clerking on the trading floor prior to his Exchange employment.

floor surveillance, and investigate potential rule violations. The clerk performs administrative functions and conducts certain audit trail review procedures. The Exchange's trade practice surveillance staff also includes a project coordinator, one trade practice secretary, and one administrative assistant.

Investigations are assigned to analysts based on managers' assessments of analysts' workloads and experience. In addition, analysts are assigned both NYMEX and COMEX investigations. Rather than being assigned to a particular manager, analysts rotate to all types of assignments and work with all of the managers on a rotating basis in order to learn from the particular expertise and experience of each of the various managers. However, analysts may be assigned to specific markets, either to support ongoing investigations or to address current market conditions.³²

The Exchange appears to have adequate staffing levels to monitor its markets.

B. Electronic Surveillance

As stated earlier, TXN is the Exchange's computerized surveillance program used to detect possible trading violations, and to assist in the investigation of trade practice abuses for both open outcry and ACCESS trading. TXN is a flexible system that permits analysts to select default parameters in order to create customized reports that focus on particular types of trading violations, members, or suspected patterns of violations. TXN provides two standardized surveillance screens, the trading ahead and prearranged trading reviews, that are reviewed daily by analysts. The trading ahead program displays instances where a broker appears to have traded ahead of either his or her own customer order or the customer order of an associated broker. The prearranged trading report displays instances where a broker may have directly or indirectly

³² Transcript at p. 9.

taken the opposite side of either his or her customer order or the customer of an associated broker. Both reports display any potentially profitable offsetting trades for each displayed exception.

In addition to the standardized daily screens, Compliance Department staff uses TXN's "Analysis" functionality, which provides pattern recognition capability. Analysis detects patterns of trading activity for one or more brokers that suggest possible abusive practices with respect to trading ahead, prearranged trading, and "fairness" of fill prices.³³ Analysis examines all cleared data quarterly and calculates the number of times that sequences of trades involving the same brokers present similar sets of fact patterns. Collections of such fact patterns that are statistically significant from a trade practice surveillance perspective are grouped by TXN into "leads." Thus, leads suggest trading relationships between brokers statistically based on the patterns of trading in which they appear to be engaged.

In addition to the quarterly generation of leads, Analysis examines each day's trading activity to determine if any new trades fit the pattern identified in the lead. If they do, a tally is presented in a summary screen to show the analyst that the identified pattern appears to be continuing. Compliance staff can refer to leads during the course of daily reviews, as well as in connection with inquiries and investigations, to determine whether expansion of the inquiries or investigations to include other relevant parties and patterns is warranted. Analysts also open inquiries and investigations based upon leads.³⁴

³³ "Fairness" is a specific type of trade event analysis that looks at the difference between the price at which a trade occurred and the prices of adjacent trades. This analysis helps analysts identify situations where one broker may be getting an advantage on trades over other brokers, indicating that the broker may be involved in a relationship with one or more members that results in profits.

³⁴ The distinction between an inquiry and an investigation is that the latter involves a request for documents that are not already under the control of the Exchange. In an inquiry, only documents available through Exchange sources including, among other things, the Streetbook, time and sales, and pit cards are reviewed.

Since the Division's last rule enforcement review of NYMEX's trade practice programs in 2000 ("2000 Review"), the Exchange has developed several new TXN applications and programs, including: (1) "High/Low Open/Close Streetbook"- a Streetbook viewer that extracts trades executed at the high and low of the day and/or the high or low of any specific time period, such as the open or close; (2) "E-miNY Applications"- programs developed to monitor e-miNY contracts traded on the Chicago Mercantile Exchange's GLOBEX platform;³⁵ (3) "PJM Electricity"- programs developed to monitor permittee trading in PJM electricity;³⁶ (4) "Spread Trades Viewer"- an application to conduct spread queries that match up individual legs of a spread transaction; (5) "Trade Sequencing for Trading Ahead"- a mathematical algorithm that assigns a probability to each trading ahead exception identified on the daily trading ahead report based on time and sales;³⁷ (6) "Profit and Loss Hedge Index"- a program that monitors day trading accounts for fraudulent trading activity; and (7) "Fast Match" - an application to identify illegal cross trades entered on ACCESS.³⁸ In addition, staff has access to a non-TXN software application, "Business Objects," to assist in the review of ACCESS trading. Business Objects includes log-on, terminal user, and other information such as allocation and time of order entry

³⁵ NYMEX's e-miNY contracts are 50 percent of the size of NYMEX's standard-size contracts and trade virtually around the clock on the Chicago Mercantile Exchange's GLOBEX electronic trading platform and clear through the NYMEX clearinghouse. The only e-miNY contracts currently trading are the Henry Hub Natural Gas futures and Light Sweet Crude Oil futures.

³⁶ NYMEX began trading the PJM Electricity contract in April 2003, and has licensed nonmember permittees meeting certain financial requirements to trade the contract on the Exchange floor. The PJM electricity permittees also are authorized to place orders with members in Natural Gas in order to execute a "spark spread" transaction between PJM Electricity and Natural Gas. The PJM Electricity TXN applications monitor permittee floor trading to ensure that they are not violating any Exchange rules.

³⁷ The daily trading ahead program identifies all trades executed by a broker ahead of a customer order within a three-minute window. TXN's Trade Sequencing for Trading Ahead application compares each trading ahead exception to time and sales prints and assigns a probability that assists analysts in determining which exceptions should be pursued further. For example, the Trade Sequencing for Trading Ahead application may find that based on time and sales, the only time that the broker could have executed a personal trade was after the customer order. The algorithm then would assign a zero probability to the exception.

³⁸ NYMEX Rule 6.40A requires that an electronic trader or a NYMEX ACCESS operator allow an order to rest in

that is not typically available on TXN.³⁹

C. Floor Surveillance

Compliance Department staff routinely observes trading in each contract market on the open and close, at a random time during the trading day, and when special market conditions warrant. Among other things, floor surveillance is used to determine the physical location of members relative to other members and to determine members' affiliations with other members; to document various floor trading practices; to identify trading patterns that are unusual for particular members; and to deter trading abuses, such as noncompetitive trading and trading before the open or after the close.

Two analysts are assigned to observe the opening, one analyst is assigned to observe the markets for at least 20 minutes during the middle of the day, and all analysts who are available observe the daily close. Analysts also routinely perform floor surveillance as part of the investigative process for cases to which they are assigned. Floor surveillance observations are recorded in the "Weekly Floor Surveillance Log."⁴⁰ The Division's review of the log disclosed that floor surveillance was conducted in accordance with the Exchange's schedule. During the target period, one inquiry and three investigations into possible trade practice violations were opened based on floor surveillance observations.⁴¹

the system for at least 10 seconds before crossing that order.

³⁹ The Business Objects application is maintained by the NYMEX Customer Service Call Center ("NCSCC").

⁴⁰ Sample copies of the Weekly Floor Surveillance Logs can be found in Appendix 5.

⁴¹ The inquiry and three investigations opened from floor surveillance involved allegations of prearranged trading. Inquiry 89-03, which was subsequently converted into Investigation 04-429, was opened based on staff's hearing of a conversation between two phone clerks concerning the prearrangement of a natural gas trade. Investigation 04-431 was opened based on staff's observation of a member negotiating trades before the Exchange's "post-close" session. Investigation 04-357 was opened based on observation of activity among a group of members prior to the beginning of the closing period. Investigation 04-429 was closed after the target period with no action. Investigation 04-431 currently is pending with the BCC and the Compliance Department is preparing an

D. Adequacy of Investigations

During the target period, the Exchange opened 109 investigations generated from a variety of sources including direct review of TXN screens and the Streetbook (46), floor surveillance (three), floor order ticket and branch office order ticket reviews (13), referrals from other Exchange departments (22), Division referrals (four), customer complaints (11), and member and anonymous complaints (10). The potential violations identified included, among other things, trading ahead of customer orders, prearranged and noncompetitive trading, improper cross trades, misallocation of fills, and unauthorized trading.

To evaluate the adequacy of the Exchange's investigations, the Division examined all of the 105 investigations closed during the target period. Of those 105 closed investigations, 20 resulted in the referral of members to the BCC for disciplinary action. Forty-four investigations resulted in the issuance of 74 Compliance warning letters, three investigations resulted in the issuance of five advisory letters, one resulted in a verbal warning, and 37 investigations were closed with no further action recommended.⁴²

The Division found that the Exchange conducted thorough, well-documented investigations and made appropriate analyses. Investigation files contained underlying trading documents, reconstructions of trading sequences, cassettes of tape-recorded interviews, correspondence, computer reports, and investigation and activity logs. The Division also found that closeout sign-off sheets and closeout memoranda prepared for investigations closed with no further action or for which Compliance warning letters were issued adequately explained

investigation report to refer Investigation 04-357 to the BCC for disciplinary action.

⁴² An advisory letter reminds a member of Exchange rule provisions that may apply to a member's conduct and serves to put a member on notice that the Exchange views certain actions as potential rule violations. Unlike a warning letter, the fact that an advisory letter has been issued will not be relayed to a disciplinary committee during

Compliance staff's rationale and were supported by proper analyses. Similarly, investigation reports for matters forwarded to the BCC for disciplinary action included detailed analyses of the violative trades and supporting evidence, and clearly articulated staff's conclusions and recommendations. The Division also found that investigations were expanded in scope to include additional trading activity and members, as appropriate.

During the target period, the Exchange set a goal of closing its aged investigations and reducing the average age of its open investigations to less than one year. In this regard, the 105 investigations closed by the Exchange during the target period included 16 investigations that had been open for more than a year.⁴³ Thirteen of these investigations were referred for disciplinary action and Compliance warning letters were issued in connection with the remaining three investigations. The Exchange explained that the delay in closing the older cases was due to several factors including, among other things, extreme volatility in the natural gas market that resulted in difficult and time consuming investigations; Compliance staff involvement in addressing a series of anonymous complaints, some involving individuals who already were the focus of ongoing investigations; and changes within the trade practice group that resulted in the reshuffling and reassignment of investigations. Further, several of the investigations required numerous trade reconstructions and/or requests for and review of additional trading documents, and required numerous drafts of investigation reports.⁴⁴ By the end of the target period in December 2003, there were no investigations on the Exchange's log open for more than one year.

a subsequent case.

⁴³ The 16 investigations included 12 that had been open for more than one year and four that had been open for more than two years.

⁴⁴ See Transcript, pp. 14-22.

E. Conclusion and Recommendations

The Division found that the Exchange maintains an adequate trade practice surveillance program administered by an experienced staff. Compliance staff conducts floor surveillance on a daily basis and uses TXN, a sophisticated computerized trade surveillance system, to detect and investigate potential trade practice violations. During the target period, the Exchange closed 105 investigations, 20 of which were referred for disciplinary action. The activity examined included, among other things, trading ahead of customer orders, prearranged and noncompetitive trading, improper cross trades, misallocation of fills, and unauthorized trading. The Division found that investigations were thorough and well documented. Sign-off sheets, closeout memoranda, and investigation reports included sufficient analyses to support Compliance staff's conclusions. In addition, investigations were expanded in scope and/or time to include additional trading sequences and members where appropriate. During the target period, the Exchange focused on closing older investigations. By the end of the target period, there were no investigations on the Exchange's log open for more than one year.

Based on the foregoing, the division has no recommendations in this area.

V. DISCIPLINARY PROGRAM

Core Principle 2 - Compliance With Rules:

The board of trade shall monitor and enforce compliance with the rules of the contract market, including the terms and conditions of any contracts to be traded and any limitations on access to the contract market.

Core Principle 2 requires that exchanges take effective disciplinary action whenever a rule violation is suspected. Disciplinary actions must be prompt and conducted pursuant to clear and fair standards. Exchanges must have the authority to discipline, suspend, or terminate the activities of members or market participants found to have committed rule violations.

A. Disciplinary Committees and Procedures

1. The Business Conduct Committee

NYMEX has two primary disciplinary committees, the BCC and the Adjudication Committee.⁴⁵ The BCC's principal function is to determine if a reasonable basis exists for finding that a rule violation occurred. It consists of a Chairman, nine Committee members, and four alternates. The Chairman selects the members and alternates, subject to the Board of Directors' approval. The BCC must include at least one non-member, and must be balanced among floor brokers, locals, commercials, and FCMs. During the target period, 30 percent of the members of the BCC were required to be COMEX members.⁴⁶

As noted earlier, the Exchange's Compliance Department investigates possible rule violations and prepares a formal investigation report if it concludes that there is a reasonable basis to believe that a rule violation has occurred.⁴⁷ Once an investigation report is completed, it

⁴⁵ During the target period, the Adjudication Committee was divided into 4 panels, two for NYMEX matters and two for COMEX matters. Similarly, there were two BCC panels during the target period. NYMEX Rules 3.10 and 3.13.

⁴⁶ NYMEX Rules 3.10 and 3.13.

⁴⁷ NYMEX Rules 8.00 and 8.01.

is served on the respondent(s). Respondents have five business days to submit a response to Compliance, which then forwards the report and any responses to the BCC. Typically, the BCC panel considering the matter meets five business days after receiving the investigation report.⁴⁸ Compliance staff is present during the panel's review of the investigation report. Respondent(s) who have submitted a response may personally appear before the panel after Compliance's presentation of the report and before the panel's deliberations. If the BCC concludes that a reasonable basis exists for finding that a Rule violation occurred, it may issue a Complaint. In the alternative, the BCC may return the matter to Compliance with instructions for further action, or it may issue a warning letter.⁴⁹

At any time prior to the submission of an investigation report to the BCC, the respondent and Compliance may negotiate and enter into a written settlement agreement, subject to BCC approval.⁵⁰ Likewise, concurrent with its review of an investigation report, the BCC may approve a settlement agreed upon by Compliance and the respondent ("Joint Offer of Settlement") or a settlement submitted by the respondent only ("Unilateral Offer of Settlement"). The BCC may also entertain Joint and Unilateral Offers of Settlement after a Complaint has been issued, but prior to service of the Complaint on the Chairman of the Adjudication Committee.⁵¹

⁴⁸ Transcript, pp. 194-195.

⁴⁹ NYMEX Rule 8.02.

⁵⁰ The settlement offer may provide for a cease and desist order, a censure, an order directing restitution to any injured person, and a fine not exceeding \$5,000 for each Rule violation alleged. NYMEX Rule 8.03(A).

⁵¹ Joint and Unilateral Offers of Settlement may provide for a cease and desist order, a censure, an order directing restitution to any injured person, a fine not exceeding \$25,000 per each alleged rule violation, and expulsion or suspension from all or some membership rights and privileges for a period not to exceed three months for each Rule violation alleged. *See* NYMEX Rule 8.03(B), (C), and (D).

2. Adjudication Committee

The Adjudication Committee consists of a Chairman and two panels, each of which has ten members and an unspecified number of alternates.⁵² The Chairman selects the members and alternates, subject to the Board of Directors' approval. Each panel of the Committee must include at least one non-member, and must be balanced among floor brokers, locals, commercials, and FCMs. With respect to major disciplinary actions, more than 50 percent of an Adjudication Committee panel must be comprised of persons representing membership interests other than that of the respondent.⁵³

Upon receiving a Complaint, the Adjudication Committee Chairman assigns it to one of the two NYMEX hearing panels. The hearing panel to which the case is assigned will adjudicate the case and the other hearing panel, hereinafter referred to as the "settlement panel," will evaluate any settlement offers made from this point forward. At any time after a Complaint is filed with the Chairman of the Adjudication Committee, respondents may submit Unilateral Offers of Settlement to the settlement panel. The Compliance Department may recommend that the panel approve or reject the settlement offer.⁵⁴ Likewise, Compliance and respondent may submit a Joint Offer of Settlement. All BCC and Adjudication Committee settlements are subject to approval by the Exchange's Board of Directors.⁵⁵

⁵² NYMEX Rule 3.10.

⁵³ "Major disciplinary actions" include those brought for any violations of the rules except those rules related to decorum or attire; financial requirements; or reporting or recordkeeping. NYMEX Rules 3.03(A)(5)(i) and 3.11A(D)(f)(ii).

⁵⁴ Adjudication Committee settlement offers may provide for a cease and desist order, a censure, an order directing restitution to any injured person, a fine not exceeding \$1,000,000 for each rule violation alleged, and expulsion or suspension from all or some membership rights and privileges. NYMEX Rule 8.08(A).

⁵⁵ NYMEX Rules 8.03(E) and 8.08(B).

B. Adequacy of Sanctions

During the target period, the Exchange took final disciplinary action against 16 members, one member firm, and one clearing member firm in 16 separate cases.⁵⁶ All of the disciplinary cases were resolved through Adjudication Committee settlement agreements. The settlement agreements resulted in fines totaling \$2,718,500 (one fine accounted for \$2,500,000), five suspensions, and three instances of customer restitution totaling \$27,510.

The Division found that the sanctions imposed in the majority of the 16 cases appeared reasonable relative to the violations committed. For example, Docket No. 03-03, a market surveillance investigation with trade practice elements, resulted in a \$2,500,000 fine assessed against a NYMEX clearing member for, among other things, position limit violations and wash trading. The Division believes that this case is noteworthy for the efficiency with which it was handled, and for the meaningful sanction imposed. It includes not only a substantial monetary penalty, but also the requirement that the clearing member develop written procedures to prevent a repetition of the violations that took place.

Of the remaining 15 cases finalized during the target period, 11 involved trade practice violations and four involved recordkeeping violations. The 11 trade practice cases, involving 14 members, resulted in five suspensions, three instances of customer restitution, and \$208,000 in fines. Two of the 11 cases involved ACCESS trading.

The most notable sanctions include a \$25,000 fine, three-week suspension, and \$25,350 in restitution assessed against a single member to settle two Complaints alleging noncompetitive trading, prearranged trading, dishonest conduct, false testimony to the Exchange, fraud or bad faith, and other violations. A second respondent in one of these cases was assessed a \$10,000

⁵⁶ Two respondents appeared each in two separate cases. One settled his two cases independently, the other settled

fine and \$750 in restitution.

Another substantial trade practice sanction was a \$60,000 fine against one member and a \$25,000 fine and one-week suspension against another member in a single case alleging noncompetitive and prearranged trading. Similar allegations resulted in a two-year suspension and a deferred \$5,000 fine against a member in one case, and fines of \$30,000 and \$20,000 against two members in two other cases. Finally, a trade practice case originating from a Division referral resulted in a \$5,000 fine, one-week suspension, and \$1,450 in restitution for trading ahead of customer orders.

The Exchange also assessed a total of \$5,500 in fines in three cases involving members who committed a fourth infraction of the Exchange's trading card rules. In addition, a \$5,000 penalty was assessed in a single case against a member who failed to submit his pit cards in a timely manner.

Although the Division found that the sanctions imposed in a majority of the 16 cases finalized during the target period appear reasonable relative to the violations committed, the Division also found five cases with which it is concerned. In each of these cases, the Adjudication Committee did not follow Compliance staff's recommendations for more substantial sanctions, sometimes with respect to repeat offenders. Some cases raise concerns as to the adequacy of the sanctions imposed by the Adjudication Committee. In addition, in two of the five cases, restitution was calculated and recommended by Compliance, but was not included in the final settlements.⁵⁷

In Docket No. 02-17, which involved violations of NYMEX Rule 6.22(E): Acceptance of

his cases through a single settlement agreement.

⁵⁷ In its 2000 Rule Enforcement Review, the Division recommended that the Exchange "order restitution in all

Orders for Entry Into NYMEX ACCESS, the Complaint charged that, in 30 instances relating to 19 bunched orders for multiple accounts, the respondent firm temporarily placed trades in a holding account belonging to its largest ACCESS customer and later reallocated the trades, albeit correctly, to various accounts at different clearing members. The respondent and Compliance staff agreed to a Joint Offer of Settlement in which the respondent would pay a \$5,000 fine.

However, despite the pre-existing settlement between the respondent and Compliance, the Adjudication Committee settlement panel determined to lower the respondent's fine to \$2,500. Senior Compliance staff expressed their "strong disagreement" with the panel's decision, explaining that a \$5,000 fine was appropriate since the respondent had been given numerous warning letters, thereby escalating the severity of the violation.⁵⁸ The Committee minutes state that the panel lowered the fine because the Complaint made no mention of warning letters issued to the respondent. However, this appears to be incorrect, as the Complaint did indicate that a warning letter was previously issued, stating: "In November 2001, Staff reviewed [respondent's] procedures for entering orders into NYMEX ACCESS on various trade dates in November 2001 and issued a Staff Warning Letter for failing to comply with NYMEX Rule 6.22(E)." Indeed, the case before the Adjudication Committee arose as a follow-up to the November 2001 review and Staff Warning Letter.

settlements and Exchange disciplinary actions where the amount of customer harm can be determined."

⁵⁸ Adjudication Committee Minutes, NYMEX Panel A, April 3, 2003.

In Docket No. 01-10, the respondent was referred to the BCC for repeated violations of NYMEX Rule 6.90(D), which requires a seller to submit a pit card within one-minute of each transaction. Members with less than an 80 percent compliance rate are subject to warning letters, escalating summary fines, and referral to the BCC for formal disciplinary action.⁵⁹ In this case, the respondent, a crack spread trader with a long record of Rule 6.90(D) violations, was referred to the BCC after receiving multiple warning letters and paying \$35,500 in 11 summary fines for the 16-month period from September 1999 to December 2000. Subsequent to the Complaint being issued in May 2001, but prior to its settlement in June 2003, the respondent continued to violate Rule 6.90(D), failing to meet the 80 percent standard six times in 2001 and eight times in 2002. Since 1995, the respondent has paid approximately \$100,000 in fines for failure to comply with Rule 6.90(D).⁶⁰

The respondent offered to settle Docket No. 01-10 with another \$5,000 fine. Compliance opposed the offer, citing the “exceptionally repetitive” nature of the respondent’s violations. Compliance recommended instead a \$25,000 fine, with \$20,000 suspended if the respondent complied with Rule 6.90(D) for a six-month period. Nevertheless, the Adjudication Committee settlement panel approved the respondent’s \$5,000 Unilateral Offer of Settlement.

In another case, Docket No. 02-13, involving two instances of non-competitive and prearranged trading, failure to provide original trading cards to Compliance, and failure to adhere to a prior cease and desist order, Compliance recommended a one-week suspension and a \$7,500

⁵⁹ See footnote 11 for a complete description of the summary fine schedule.

⁶⁰ During the target period, the respondent was also charged with violating NYMEX Rule 6.90(B), which, among other things, requires that members indicate the time of execution next to the first transaction on each trading card. The Complaint in Docket No. 02-14 alleged that respondent failed to indicate the time of execution next to the first transaction on 53 of the 54 trading cards reviewed by Compliance. It also alleged that respondent failed to mark through unused lines in two instances, and failed to identify the open and/or close in 15 instances. The respondent settled these charges with a \$1,500 fine. Similar infractions resulted in the respondent receiving a warning letter in July 2000, a \$100 fine in December 2000, and a \$500 fine in May 2001.

fine. In addition, the investigation report that supported the Complaint stated that “there is a reasonable basis to believe that [respondent] and [counterparty] changed the price on a completed trade to the detriment of [respondent’s] customer....[T]he price change...resulted in damage to [respondent’s] customer in the amount of \$920.” The settlement panel, however, accepted the respondent’s Unilateral Offer of Settlement for a two-day suspension and a \$5,000 fine. The panel did not include restitution in the final settlement.⁶¹

Likewise, in Docket No. 03-06, which involved 84 instances of making or reporting of false or fictitious trades and engaging in wash trading in ACCESS contracts, Compliance sought a one-week suspension, a \$5,000 fine, and a cease and desist order.⁶² The settlement panel, however, accepted the respondent’s Unilateral Offer of Settlement, agreeing to no suspension, a \$2,500 fine and a cease and desist order.

Finally, in Docket No. 03-02, Compliance recommended a one-week suspension, a \$7,500 fine, and restitution against two floor members for engaging in non-competitive, prearranged trading, and indirectly taking the opposite side of customer orders. Compliance determined that the customer was disadvantaged by \$998. The customer’s loss was included in the investigation report and the Complaint, and was raised before the settlement panel. In the final settlement, however, the panel lowered the fines against each respondent by \$1,000, did not suspend either member, and did not order restitution to the aggrieved customer.⁶³ In the majority

⁶¹ In 1999, facing similar charges, the respondent was sanctioned with a two-week suspension and a \$7,500 fine. The Division notes that under NYMEX rules, such violations require suspension in the absence of mitigating circumstances. Specifically, NYMEX Rule 8.55 states that “unless good cause is shown, any offense involving fraudulent or deceitful trading practices detrimental to a customer’s order...shall be punishable, at a minimum with a suspension or revocation of the Member’s...right to execute customer orders.”

⁶² Of the 84 instances, 65 involved trades of one contract in size, and the remaining 19 involved trades between two and 10 contracts. The member made no profit on any of this activity and no customer orders were involved. Compliance’s recommendation was based, in part, on the fact that the member’s only apparent goal was to create the appearance of activity to generate interest in an otherwise slow market.

⁶³ NYMEX Rule 8.55 is relevant here as well. *See* footnote 61.

of the above cases, the Adjudication Committee meeting minutes were silent with respect to the Committee's rationale for not following Compliance's recommendations.

C. Timeliness of Disciplinary Process

The Division found that, with one exception, the disciplinary cases were handled in a timely manner. In 14 of the 16 cases settled during the target period, the BCC issued a Complaint less than 90 days after receiving Compliance's investigation report, including eight cases in which Complaints were issued within 30 days and four cases in which complaints were issued within 60 days. In addition, 13 of the 16 cases were settled within approximately six months of the issuance of a Complaint, and two additional cases were settled within one year.⁶⁴ Further, all settlements were submitted to the Board of Directors for final approval in a timely fashion, and all fines owed have been collected.

D. Conclusions and Recommendations

During the target period, the Exchange took final disciplinary action in 16 cases, all of which were resolved through settlement agreements at the Adjudication Committee. The Division found that the sanctions imposed in the majority of the 16 cases appear reasonable relative to the violations committed. The settlement agreements resulted in fines totaling \$2,718,500, including a \$2,500,000 fine in a market surveillance case with trade practice elements. Eleven of the 16 cases involved trade practice violations, where sanctions reached as high as a \$25,000 fine, three-week suspension, and \$25,350 in customer restitution in a settlement resolving two Complaints against one member. The single largest trade practice fine

⁶⁴ The lone exception was Docket No. 01-10, discussed above, where approximately two years passed from the time the BCC issued the Complaint to the time the Adjudication Committee accepted the respondent's Unilateral Offer of Settlement. The delay was caused in part by the events of September 11, 2001. In addition, the Exchange gave the respondent more than a year to attempt to improve his compliance with the one-minute trade-timing rule before proceeding with the disciplinary action against him.

was \$60,000. Four of the 16 cases finalized during the target period involved recordkeeping violations, where sanctions ranged from \$1,500 to \$5,000.

At the same time, the Division identified five cases with which it is concerned. In each of these cases, the Adjudication Committee did not follow Compliance staff's recommendations for more substantial sanctions, sometimes with respect to repeat offenders. Some cases raise concerns as to the adequacy of the sanctions imposed by the Adjudication Committee. In addition, in two of the five cases, restitution was calculated and recommended by Compliance, but was not included in the final settlements.

Based on the foregoing, the Division recommends that:

- **Exchange disciplinary committees should give careful consideration to Compliance staff's recommended sanctions, and, in those instances where the committees' sanctions ultimately differ from those recommended by Compliance, the committees should articulate their rationale in committee minutes.**
- **Exchange disciplinary committees should ensure that all sanctions and settlements are sufficient to serve as an effective deterrent, particularly in those cases involving repeat offenders.**
- **Restitution should be ordered in settlements and Exchange disciplinary decisions where the amount of customer harm can reasonably be determined.**

VI. DISPUTE RESOLUTION PROGRAM

Core Principle 13 - Dispute Resolution

The board of trade shall establish and enforce rules regarding and provide facilities for alternative dispute resolution as appropriate for market participants and any market intermediaries.

Pursuant to acceptable practices set forth in Appendix B to Part 38, an exchange is required to provide customer dispute resolution mechanisms that are fair, equitable, and available on a voluntary basis. Customers should have the opportunity to have their claims heard and decided by an objective and impartial decision maker. In addition, each party should have the right to counsel, adequate notice of claims presented against him or her, and an opportunity to be heard on all claims, defenses, and counterclaims. The process should provide for a prompt hearing, as well as prompt, written, final settlement awards that are not subject to appeal within the exchange. The parties also should be notified of the fees and costs that may be assessed. Finally, if an exchange provides procedures for the resolution of member-to-member disputes (not involving customers), the procedures for resolving such disputes must be independent of, and not interfere with, the resolution of customers' claims or grievances.

A. Customer Arbitration

Exchange customers are afforded voluntary dispute resolution through procedures set forth in NYMEX Rules 5.01 through 5.38. Matters subject to arbitration include any claim or grievance between a customer and a member or an employee of a member or member firm that arises as a result of any transaction on or subject to the rules of the Exchange. If two years or more have passed since the event that gave rise to the claim or grievance, the matter may no longer be arbitrated.⁶⁵

⁶⁵ NYMEX Rules 5.04(B) and 5.10. Under NYMEX Rule 5.11, the two-year limitation tolls when the parties have

Arbitration proceedings are initiated when the party desiring to submit a matter to Arbitration (“claimant”) files with the Exchange three executed copies of a Statement of Claim (“Statement”) setting forth a concise description of the claim or grievance and the name and address of the person(s) from whom relief is sought (“respondent”). The claimant must also provide any documents and the names of witnesses upon whom it intends to rely to support its claim. The Statement should specify the relevant facts, the remedies sought (including the method by which damages were computed), and the basis upon which relief is sought. The Statement must be accompanied by payment of an arbitration fee ranging from a minimum of \$100 for claims up to \$5,000, to a maximum of \$1,150 plus one-half of one percent of any amount over \$100,000.⁶⁶

A copy of the claimant’s Statement must be provided promptly to the respondent, who then has 20 days to file an Answer and any Counterclaims with the Exchange. If no Answer is filed, the allegations in the Statement are deemed denied. The Counterclaims of a member respondent against a customer must arise out of the transaction or occurrence that is the subject of the customer’s claim or grievance. The claimant must respond to any such Counterclaims within ten days.⁶⁷

In the case of customer-member arbitrations, an arbitration panel usually consisting of three persons is appointed by the Chairman of the Arbitration Committee. At the customer’s request, two of the panel members must be persons who are not members of, or associated with,

filed their Statement of Claim and Answer.

⁶⁶ NYMEX Rule 5.37(A).

⁶⁷ NYMEX Rule 5.18(A)(2).

a member of any commodities exchange.⁶⁸ If a matter involves a dollar amount not exceeding \$2,500, it will be decided by a single arbitrator appointed by the Chairman of the Arbitration Committee, and may be decided without a hearing. If a customer is a party, he may request that the sole arbitrator not be a member of, or associated with a member of, any commodities exchange.⁶⁹

The Exchange must notify the parties in writing of the name and business affiliation of each arbitrator at least twenty days prior to the date fixed for the initial hearing session.⁷⁰ The parties have the right to file written objections to particular arbitrators with the Chairman of the Arbitration Committee. Panel members have a continuing obligation to notify the Chairman of any direct or indirect financial or personal interest in the outcome of the arbitration, and any existing or past professional, family, or social relationship with any party, its counsel, or any individual whom they have been told will be a witness, which are likely to affect impartiality or create an appearance of bias.⁷¹ The parties must be notified of any such notifications and may file written objections with the Chairman.

Arbitration proceedings are held at a time and place determined by the Exchange. Each party has the right to be represented by counsel.⁷² Each party also has the right to present its claims, defenses, counterclaims, evidence, and witnesses. Prior to hearing, parties may formally request relevant documents and information from other parties. Each party also must provide the

⁶⁸ The customer's Statement of Claim must specify whether the customer wishes the controversy to be heard by an arbitration panel that is comprised of a majority of persons not associated with a member of any commodities exchange. NYMEX Rules 5.07(B) and 5.18(A)(1)(a).

⁶⁹ NYMEX Rule 5.09.

⁷⁰ NYMEX Rule 5.16.

⁷¹ NYMEX Rule 5.14(A).

⁷² NYMEX Rule 5.19.

Exchange and other parties with copies of any documents they intend to use at the hearing and the names of all witnesses who may testify on their behalf. Parties may examine witnesses appearing at hearing. The arbitrators, at the request of any party, may direct the appearance of any member, or any person employed by or associated with any member, who is not a party to the arbitration. They may also direct the production of any records in the possession or control of such persons.⁷³

Arbitration panels must make every effort to render a decision within 30 days from the date the record is closed. The decision must be in writing and signed by a majority of the panel. The panel may award damages sought, and may assess arbitration fees, expenses, and costs associated with the hearing against the losing party. The panel may also assess against a party all or any portion of the reasonable attorney fees incurred by any other party upon finding that it advanced a frivolous claim or defense, or engaged in willful acts of bad faith during the course of the arbitration.⁷⁴

Any award granted to a claimant against a member or an employee of a member must be paid within ten business days after the member or employee is notified of the award. Failure to satisfy an award is a violation of Exchange rules and grounds for automatic suspension from all rights and privileges of membership. Awards are final and not subject to Exchange review or appeal. Awards may be entered as a judgment in any court of competent jurisdiction.⁷⁵

⁷³ NYMEX Rules 5.24 and 5.26.

⁷⁴ NYMEX Rule 5.36(A) and (E).

⁷⁵ NYMEX Rule 5.36 (A), (B), and (F).

B. Member-to-Member Arbitration

The Exchange's member-to-member arbitration procedures generally are similar to those for customer arbitration. However, members and member firms must arbitrate any claim or grievance arising wholly or partially, directly or indirectly, out of, in connection with, or as a result of: (1) any transaction executed on the Exchange; and (2) the business of such member or member on the Exchange. Also, arbitration panels for member-to-member disputes consist only of members or members' employees.⁷⁶ Parties in member-to-member arbitrations also have the right to representation by counsel.⁷⁷

C. Arbitrations During the Target Period

Four arbitrations were brought during the target period. Of these, two involved customer-member disputes and two involved member-to-member disputes. One, a member-to-member arbitration, was settled during the target period. The Division's review of the file found that the dispute was handled in conformance with the Exchange's arbitration rules and procedures, and was completed in a timely manner.

D. Conclusions and Recommendations

The Division found that the Exchange's arbitration rules provide fair and equitable procedures for the resolution of customer and member disputes. Customers have the opportunity to have their claims heard by unbiased panels, including panels where a majority of the panelists are not members of, or associated with, any member of a contract market. Each party has the right to counsel. Each party also receives adequate notice of the claims against it, and has an opportunity to present all of its claims, defenses, and counterclaims. In addition, the Exchange's

⁷⁶ NYMEX Rule 5.07(A).

⁷⁷ NYMEX Rule 5.19.

arbitration rules require a prompt hearing and authorize prompt, written awards that are not subject to appeal within the Exchange.

The Exchange also provides adequate procedures for mandatory member-to-member arbitration, and for disciplinary action to enforce panel decisions. In addition, member-to-member arbitration is independent of customer claims submitted for resolution and does not interfere with or delay customer disputes. Finally, the Division found that the one dispute decided during the target period was resolved in accordance with Exchange rules and procedures.

Based on the foregoing, the Division has no recommendations in this area.